

PCG 2016/6 - Determining source of certain hedging gains for the purposes of section 770-75



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Relying on this Guideline

This Practical Compliance Guideline sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow this guideline in good faith, the Commissioner will administer the law in accordance with this approach.

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What this Guideline is about

1. These Guidelines set out the ATO's compliance approach to working out the source of certain hedging gains for the purposes of calculating the foreign income tax offset limit in section 770-75 of the *Income Tax Assessment Act 1997* (ITAA 1997)¹. You do not have to rely on these Guidelines, but if you do, these Guidelines provide additional, practical certainty that you are acting in accordance with the ATO's view of the law.

¹ All legislative references in this Guideline are to the ITAA 1997 unless otherwise indicated.

Date of effect

2. These Guidelines apply on and from 1 July 2015. This means that you can choose to rely on these Guidelines at any time on or after 1 July 2015.
3. The ATO recognises that there may be other methods you choose to demonstrate reasonable compliance with the ATO's view of the law, which is set out in TR 2014/7².
4. Given that the Guidelines have not been available for all of the 2016 income year, the ATO recognises that the means for obtaining the requisite information will still be evolving. For the 2016 income year, and if you choose to rely on these Guidelines, you will be taken to be acting in accordance with them if you are making a genuine attempt to move toward an approach based on the Guidelines.

What transactions will this guidance apply to?

5. These guidelines apply to foreign currency hedging transactions undertaken as part of a hedging strategy relating to a portfolio of assets for the purposes of section 770-75. This guidance does not apply in relation to other transactions or for other purposes.

Who will this guidance apply to?

6. These guidelines apply to Australian entities which:
 - enter into hedging transactions to manage the currency risk associated with holding a portfolio of (foreign) assets
 - enter into those transactions directly or via an independent hedge manager acting as agent for the Australian entity
 - enter into a large number of transactions such that it is impractical to work out the treatment of each transaction
 - are required to determine what proportion of gains from the hedging transactions are not from an Australian source in order to determine their foreign income tax offset (FITO) limit under section 770-75

where:

- the transaction is governed by an International Swaps and Derivatives Association Master Agreement (Master ISDA) (whether or not other contractual terms also apply, such as those applying to the particular electronic platform being used to conduct the transaction)
- the transaction is carried out by phone, chat messaging or equivalent, or an electronic software program.

Division 770 – statutory context

7. As set out in TR 2014/7, the FITO rules in Division 770 provide relief from the double taxation that may arise where a taxpayer pays foreign tax on income that is also taxable in Australia. A non-refundable tax offset for foreign income tax paid is allowed in respect of amounts which are also included in assessable income.

² Taxation Ruling TR 2014/7 *Income tax: foreign currency hedging transactions - applying the foreign income tax offset limit under section 770-75 of the Income Tax Assessment Act 1997*.

8. Section 770-75 provides for a FITO limit which operates to limit the offset to the amount of Australian tax otherwise payable on the net foreign income (or other amounts in respect of which the taxpayer has paid foreign income tax) included in assessable income (the offset limit calculation). The offset limit calculation requires you to establish amounts which have either borne foreign tax or are not from an Australian source.

9. Whether or not income from a hedging transaction is from an Australian source is determined by reference to common law principles of source.

Common law source principles

10. As stated in TR 2014/7, the Commissioner's view is that, while source is always a practical matter of fact, the place where hedge contracts the subject of that Ruling are formed is likely to be the most important factor in determining source for such gains.³ Subject to express or implied terms to the contrary, the place where the contract is formed will be the place where the acceptance is communicated to.

Place of contract formation

11. Absent express or implied terms to the contrary⁴, or the operation of the postal acceptance rule, a contract is formed when and where the communication of the acceptance of the offer is received.⁵

12. To apply this rule to hedge contracts it is necessary to know two things:

- which party (that is, whether the liquidity provider or the Australian entity) is receiving the communication of the acceptance, and
- the location of that person, who is acting to bind the party contractually, who receives the communication of the acceptance. This may be an employee of the party, or it may be an employee of an agent acting on behalf of the party.

Compliance approach – a reasonable approach taking into account relevant matters

13. Hedging transactions can be carried out by various means. Which entity receives communication of the acceptance may be different depending on the means used, how the parties interact with each other and the terms and conditions upon which they do so. Further, the location of the entity receiving the communication of the acceptance may be different depending on when and how the transaction is carried out. Therefore, for the transactions the subject of these guidelines, we accept that it is impractical to work out the location of the person within the entity receiving the communication and hence the source of a gain on a transaction by transaction basis.

³ And because source is always a practical matter of fact, different factors may be relevant in determining source where a contractual gain arises in a different context.

⁴ And subject to the application of the *Electronic Transactions Act 1999* or equivalent legislation in place in other jurisdictions.

⁵ Clause 9(e)(ii) of the Master ISDA provides that the parties are legally bound by the terms of each Transaction from the moment they agree to those terms. That agreement is then evidenced through issuing a Confirmation. The contract is therefore formed prior to the Confirmation being issued.

14. The ATO will accept an approximation based on a reasonable approach as a means of determining the source of hedging gains. The ATO considers that an approach is reasonable if it takes into account matters which are likely to reflect which person is receiving communication of the acceptance and the location of the person receiving the communication of the acceptance. This is the fundamental principle upon which an approach must be based to be considered reasonable. Paragraphs 20-21 set out assumptions the ATO derived from extensive consultation, and will accept.

Paragraphs 26-28 set out examples of what the ATO considers to be a reasonable approach, and will accept. However, should a taxpayer's factual circumstances differ from those set out in the assumptions, the taxpayer may instead choose to rely on their factual circumstances, as long as the approach adopted reasonably reflects the location of the person receiving communication of the acceptance.

15. Whatever approach is chosen, it will need to be decided in advance and consistently adopted until there is a material change which would affect its accuracy.

16. Generally, an Australian entity can take a sample of representative transactions to determine the source using appropriate indicators and assumptions to reflect the common law principles that where the contract is formed is likely to be the most important factor in determining the source of the gain.

17. The remainder of these Guidelines sets out the following:

- Indicators which are not appropriate
- How to determine a representative sample of transactions
- How to determine to whom the acceptance is communicated
- How to determine the location of the person within, or on behalf of, the entity, to whom the acceptance is communicated
- Examples of acceptable methodologies
- An approach if all dealings are Australian or foreign

Indicators which are not appropriate

18. For the purpose of these guidelines in relation to these transactions, we do not consider an approach based on the following demonstrates reasonable compliance with the Commissioner's view of the law as set out in TR 2014/7:

- where the Master ISDA is formed
- where any payment is required to be made or received
- the location of the underlying assets
- where decisions are made regarding setting up and managing the hedging strategy
- an office specified in a confirmation, SWIFT⁶ message or similar.⁷

⁶ Society for Worldwide Interbank Financial Telecommunication.

⁷ Unless that office is a sound proxy, because of the method and time of trading, for where contracts are entered into.

Determining a representative sample of transactions

19. An Australian entity can take a sample of representative transactions to determine the source. The sample must be capable of reflecting the larger population from which it is drawn. Therefore, the period for which the sample is taken should reflect trading patterns more generally and be of sufficient length to incorporate a range of settlement dates with a range of counterparties. Where there are a very small number of especially large transactions, it would not normally be appropriate to use such a transaction in the sample. It would normally be appropriate to work out the source of very large transactions individually, and rely on the sample for the mass of smaller transactions.

20. In analysing this sample of transactions, the matters we consider relevant should be used. A methodology based on indicators we consider to be not relevant will not be accepted as a reasonable approach.

21. The Australian entity may need to rely on its hedge manager and other market participants to obtain and provide the relevant information.⁸ For example, they may need to request from their hedge manager what percentage of trades are conducted by a particular means. In this regard, we will accept samples conducted on reasonable assurances from the hedge manager and samples on the basis of information from a variety of sources which are reasonably capable of approximating the location of the person receiving the communication of the acceptance. In this regard, the Australian entity could use an approach based either on a simple proportion of trades, or a proportion of trades weighted for value, as long as the sample reasonably reflects the total population.

Determining who receives communication of the acceptance of the offer

22. The method of trading determines who receives communication of the offer. The main methods of trading are:

- Manual Trading – where the trade is conducted over the phone, by email or by an instant messaging service.
- Electronic Trading – where the trade is conducted over an electronic platform whether provided by the liquidity provider or a third party:
 - (a) Request for Price (RFP) – where the liquidity provider presents a price capable of being accepted by the Australian entity and, upon acceptance of that price and absent a ‘last look’ contractual term to the contrary, the liquidity provider is bound.
 - (b) Request for Streaming (RFS) – where the liquidity provider, via an automated process, presents a live price, the Australian client can select the price and, absent a ‘last look’ contractual term to the contrary, the liquidity provider is bound.
 - (c) Algorithmic Trading – where a trade order is filled by reference to a pre-determined set of rules allowing automated execution of a number of smaller trades aggregated to complete the order.

⁸ The ATO is advised that the details captured by Custodians in instructions relating to FX hedging contracts do not include data pertaining to place of contract formation.

23. In determining who is making the offer, we will accept an approach based on the following assumptions:⁹

- In **manual trading**, the liquidity provider makes the offer. The contract is formed in the location of the person within the liquidity provider receiving the communication of the acceptance.
- In **electronic trading without a 'last look' clause** the liquidity provider makes the offer and the Australian entity accepts. The contract is formed in the location of the person within the liquidity provider receiving the acceptance.
- However, in **electronic trading with a 'last look' clause** – where the contractual agreement governing the use of the electronic platform contains a clause the effect of which is that the liquidity provider may refuse to act on any instruction from the Australian entity – the Australian entity makes the offer and the liquidity provider accepts. The contract would be formed in the location of the person, who is acting to bind the Australian entity contractually, who receives the communication of the acceptance. (This may be an employee of the Australian entity, or it may be an employee of an agent acting on behalf of the Australian entity.)
- In **algorithmic trading**, the smaller trades entered into to make up the trade order may be a combination of contracts both with 'last look' and without 'last look'. The location of where the individual contracts are formed is determined as above.

Determining the location of the person within, or on behalf of, the entity receiving communication of the acceptance

24. We consider that the following would need to be considered:

- the location of the Australian entity or its hedge manager, including the location of any desks it may conduct trades through
- where the liquidity provider conducts trades
- the time at which the transaction is concluded.

25. What is relevant depends on the circumstances and manner in which the hedging strategy is routinely carried out. For example, if the only methods of trading used mean that it is likely that the liquidity provider is always receiving communication of the acceptance of the offer, their location is more likely to provide an accurate approximation of source. If the counterparties conduct trades through both Australian and offshore branches, the time of the trade would also be relevant.

26. A reasonable basis for working out the location of the entity acting for the liquidity provider receiving the communication of the acceptance would include considering where the liquidity provider has their operations, the hours of those operations and the time of the trade. For these purposes the ATO considers that adopting a bandwidth of 8am to 6pm by Australian Eastern Time is acceptable as an approximation of when trades would be conducted in Australian business hours.

27. Examples of what might be a reasonable basis for approximating source are set out below. These are not the only methods that can be used. Taxpayers can use any reasonable basis. However, any method used must reflect the relevant indicators of where the contract is formed.

⁹ Being assumptions, these can be displaced if, in specific fact patterns, contractual terms and methods or trading are such that the offer and acceptance analysis is different.

Examples

28. An example of a reasonable methodology might be as follows where all types of trading are used:

Manual trades with	Australian/Australian PE of Foreign Bank in offshore hours	Foreign
	Australian/Australian PE of Foreign Bank in Australian hours	Australian
	a Foreign Bank (no PE)	Foreign
Electronic trades <u>without</u> last look	Australian/Australian PE of Foreign bank in offshore hours	Foreign
	an Australian/Australian PE of Foreign Bank in Australian hours	Australian
	a Foreign Bank (no PE)	Foreign
Electronic trades with a last look clause	Australian/in-house hedge manager in offshore hours ¹⁰	Foreign
	Australian/in-house hedge manager in Australian hours	Australian
	A foreign hedge manager ¹¹ or Australian hedging manager trading offshore	Foreign

29. Where an Australian entity only conducts trades in a particular way such that it is always the liquidity provider making the offer then it may be reasonable to conduct a sample using the following indicators:

Trade is outside Australian hours irrespective of counterparties	Foreign
Trade is with a foreign counterparty (no PE) irrespective of the time of trade	Foreign
Trade is with an Australian counterparty/Australian PE of Foreign bank within Australian hours	Australian

An approach if dealings known to be all Australian or all foreign

30. Where an Australian entity can obtain reasonable assurance from its hedge manager (if used) or counterparties that all trades are routinely conducted between persons all in Australia (or all off-shore), the source will be all Australian (or foreign). This approach could be applied to all trades or it could be applied to all trades conducted with a particular counterparty (with a different, reasonable approach applied to trades with other counterparties). This would need to be revised where there was a change in counterparties or hedge manager or material change in the manner in which transactions are conducted.

Commissioner of Taxation

15 April 2016

¹⁰ This assumes the Australian hedge manager is not an Australian night desk but an FX desk.

¹¹ Unless possessing an Australian FX desk, in which case treat like Australian hedge manager.

References

ATOlaw topic(s)	International issues ~~ Foreign income tax offset International issues ~~ Forex gains and losses ~~ Gains and losses International issues ~~ Residency and source ~~ Electronic commerce
Legislative references	ITAA 1997 ITAA 1997 Div 770 ITAA 1997 770-75 Electronic Transactions Act 1999
Other references	TR 2014/7

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